

options in its simplification benefits.<sup>42</sup> Both the Depreciation Rate Range and Basic Factors Range Options cannot provide benefits, however, if they are limited by the suggestions made by some of the commenters.

One of the suggestions is to limit the size of the ranges, or to set them using the hindsight of outdated data rather than foresight.<sup>43</sup> The other suggestion is to limit the use of the range option to a few accounts, or worse, to only identified minor accounts.<sup>44</sup>

USTA's comments explained how each of these limitations would affect the benefits of both the Basic Factors Range option and the Depreciation Rate Range option.<sup>45</sup> Under these limitations, no real simplification or benefit would be achieved. Some states recognize this.<sup>46</sup> Deferral to rates or factors grounded in a past time period - one that was more technologically static, less competitive, and traditionally regulated under a strict rate base rate of return scheme - will dilute the necessary future-oriented

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<sup>42</sup>USTA Comments at 15-21.

<sup>43</sup>Oregon PUC at 2; Oklahoma CC PUD Staff at 2. See also California at 3. See also Texas PUC at 2; Consumers' Advocates at 12.

<sup>44</sup>Texas PUC at 3 (no account over 10% of investment); South Dakota PUC at 1 (omit switching and outside plant); Utah DPU at 2 (only "stable" accounts); Washington UTC at 2; Idaho PUC at 3; Missouri PSC at 2. See also early-filed Reply Comments of ICA at 3 (stable data with no controversy).

<sup>45</sup>USTA comments at 16-19.

<sup>46</sup>Wisconsin PSC at 2 (option can be used for any and all accounts.)

market focus. The Wisconsin commission suggests that this option, used even with all accounts, would provide an excellent use of resources and data.<sup>47</sup> Some comments show that it is exactly the "new technology" accounts that need changes.<sup>48</sup>

Unrealistic ranges will lead to ongoing administrative burdens as a result of the market-driven changes that carriers will continue to require. There will continue to be requests for reserve deficiency amortizations, requests for exceptions to the limiting ranges set, and requests for more depreciation rate updates. This is inevitable - the suggested limits will leave depreciation rates for most investment exactly where they have been - and the rest of the telecommunications industry will have been steadily moving ahead. On balance, the fully subject carriers will be penalized.

If the range of parameters or the range of depreciation rates is expanded to cover all accounts and is truly forward looking, these options would produce significant simplification. The first point of reliance under any simplification option must be market forces. Commission oversight can align the ranges to match the trends of technology change and economic decisionmaking. The Commission should assure that ranges are current and reflect the most recent data available. It could achieve this by reviewing the carriers' regular updates so that Commission staff will maintain good knowledge of depreciation changes and trends.

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<sup>47</sup>Wisconsin PSC at 2.

<sup>48</sup>See BellSouth at 10.

**V. NO OTHER ISSUE IS SIGNIFICANT ENOUGH TO DISQUALIFY THE PRICE CAP OPTION OR FULL USE OF EITHER RANGE-BASED OPTION WITH ALL ACCOUNTS.**

A number of other, less significant issues are raised in the comments. Each can be addressed and resolved. None are significant enough to affect the fundamental merits of the Price Cap Carrier option or the range options.

A handful of commenters suggest that equal life group depreciation (ELG) should be eliminated if any simplification is implemented in the interstate jurisdiction.<sup>49</sup> USTA disagrees. The carriers believe ELG should be continued. ELG is a procedure that provides yet additional accounting control.<sup>50</sup> The Commission examined ELG extensively in Docket 20188, and recognized that it was appropriate for use by carriers. There is no basis to revisit ELG here. ELG itself is not an issue that must be addressed to achieve simplification. The primary difference between vintage group and ELG is the formula, *i.e.*, the weighting. The Commission should not alter its existing procedures and discontinue ELG use.

Finally, a few commenters argue that simplification should be rejected because

increased investment.<sup>51</sup> This is not the role of depreciation rates. The purpose of depreciation is simply to allocate existing investment over its life.<sup>52</sup> That fundamental principle should control here. When useful lives change, the depreciation rates for the relevant assets should keep pace, regardless of procedures or prior assumptions.

**VI. NO LEGAL IMPEDIMENT EXISTS TO THE SIMPLIFYING PROPOSALS SET OUT IN THE NPRM AND IN USTA'S COMMENTS.**

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A few commenters suggest that there would remain legal defects in any simplification option, particularly in the Price Cap Carrier option.<sup>55</sup>

These arguments are spurious, and USTA addresses them in light of the Price Cap Carrier option it endorsed in its comments and addresses again above. No extended discussion is needed, because the option endorsed by USTA has no legal defects. Its details deal with every issue raised in the comments.

USTA's outline of how the Price Cap Carrier option could be implemented showed how each of the legal issues raised would be resolved:

- o The Commission would actually make a prescription, and it would exercise affirmative prescription authority.<sup>56</sup>
- o There would be opportunity for involvement by state commissions as contemplated by §220(b).<sup>57</sup>
- o There would be data and a record to substantiate the depreciation prescription decision of the Commission.<sup>58</sup>

None of the arguments complaining of legal impediments has merit.<sup>59</sup>

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<sup>55</sup>See Consumers' Counsel, *passim*; California CATV Association at 22-26.

<sup>56</sup>USTA comments at 11.

<sup>57</sup>USTA comments at 10-11.

<sup>58</sup>See section III A, *infra*.

<sup>59</sup>See also comments of Ameritech at 7-8; BellSouth at 23-24; NYNEX at 10-13; Southwestern Bell at 10-12; U S WEST at 7-9.

**VII. COMPETITION IS NOT A DISQUALIFYING FACTOR BUT A FACTOR  
PROMOTING REVISION AND SIMPLIFICATION, LIKE TECHNOLOGY.**

AT&T, the New York commission and the Tennessee and Virginia commission staff suggest that the level of competition is inadequate in the interstate access marketplace, and that depreciation simplification without more extensive competition is not yet in the public interest.<sup>60</sup> MCI argues that the reason for reserve deficiencies and depreciation problems for fully subject exchange carriers is the fact that these exchange carriers are entering competitive markets.<sup>61</sup>

MCI has the cause and effect partially backwards. Competition is thrusting itself onto all aspects of the exchange carriers' interstate access and other businesses quickly.

carriers because they want to limit the carriers' abilities to compete. They see the fully subject exchange carriers as potential competitors.<sup>62</sup>

USTA explained in its March 12, 1993 comments in response to the Commission's Public Notice on the AT&T Petition for Waiver<sup>63</sup> how technology operates as the primary driver for depreciation rate changes. A recent statement by Commissioner Andrew Barrett also shows that the level of competition facing exchange carriers is high. He said, in an interview with a publication covering local access competition, "In a very real sense, (the) RBOCs are fighting for their economic life."<sup>64</sup> This holds for all exchange carriers.

It is difficult to imagine how competition could be more threatening or operate as a greater spur to the exchange carriers given what Commissioner Barrett states. The fully subject carriers are keenly aware of the fundamental structural changes that have taken place in their business; they still struggle to remove the "conceptual regulatory lag" of conventional but incorrect wisdom, and to explain how market competition has progressed much further than is recognized by those not actively engaged in the access business.

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<sup>62</sup>AT&T's 1992 Annual Report is candid in this respect. It states that AT&T increasingly will compete with the Regional Bell Operating Companies (RBOCs) in access and other services, but simultaneously opposes the elimination of restrictions AT&T itself doesn't have. AT&T Annual Report at 19.

<sup>63</sup>Public Notice, File No. AAD 93-18, released February 11, 1993.

<sup>64</sup>Interview, Local Telecom Competition News, March 31, 1993 at 4.

### **VIII. THERE IS NO CONSENSUS FAVORING ANY CHANGE IN THE HANDLING OF SALVAGE.**

Commenters are badly divided over the merits of a change in handling of salvage. A few state commissions see a change in handling of salvage as something that will reduce revenue requirement on the intrastate level, and the potential for a quick reduction drives their position. Other states are more careful, and are unsure of the value.<sup>65</sup> USTA did not favor any change at this time.<sup>66</sup> Based on the comments, USTA still sees no reason for forcing a change at this time.

### **IX. CONCLUSION.**

The merits of depreciation rate prescription simplification are spread across the record. USTA has endorsed a forward-looking reform that will produce the maximum public interest benefit. The record discloses no basis upon which the Commission must reject reform, and many commenters, including many state commission commenters support simplification. By comparing USTA's suggestions with the specific objections of commenters, the Commission will find that the Price Cap Carrier option USTA proposed is responsive to the essential concerns of participating regulators and other objective commenters. It should be adopted. If it is not, one of the range options should be

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<sup>65</sup>See Missouri PSC at 6 (too complex); Oregon PUC at 3 (will promote inter-generational inequities).

<sup>66</sup>USTA comments at 32-33.

implemented, for all accounts, at levels that will accommodate the known trends in depreciation rates that will play out in the future.

Respectfully submitted,

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Report to the

United States

Copyright Association

April 12, 1993

# DEPRECIATION SAFEGUARDS UNDER GAAP

# DEPRECIATION SAFEGUARDS UNDER GAAP

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# **DEPRECIATION SAFEGUARDS UNDER GAAP**

## **Executive Summary**

**This paper describes the safeguards and constraints over depreciation accounting that apply to all companies, both regulated and nonregulated, under generally accepted accounting principles (GAAP), generally accepted auditing standards (GAAS), and the other institutional structures that govern financial reporting. These principles, standards, and institutional structures operate simultaneously to constrain regulated common carriers' ability to manipulate reported earnings by arbitrarily changing depreciation rates.**

Financial reporting is designed to provide information that is useful for economic decision making by shareholders, lenders, creditors, and other financial statement users (e.g., regulators).

GAAP defines how individual types of transactions are to be reported in financial statements to reflect accounting theory and the underlying economic reality. These transactions include the reported amounts of depreciation expense. GAAP is currently promulgated by the Financial Accounting Standards Board (FASB), under delegated authority from the Securities and Exchange Commission (SEC).

The need for depreciation accounting stems from one of the fundamental characteristics of accrual accounting, the matching principle, which attempts to identify cash-using or cash-generating operating events with the period when the event occurs, not when the related cash flows occur. Consequently, GAAP requires that the original cost of an asset be allocated over its expected useful life in a systematic and rational manner. In addition, GAAP requires that a variety of specific information about an enterprise's depreciation policies, as well as any changes in depreciation methods and lives, be disclosed in the enterprise's financial statements. In practice, however, material changes to depreciation methods and lives occur infrequently.

**Material changes in the level of depreciation expense would be subject to the disclosure requirements and would come to the attention of regulators and other users of the financial statements. Thus, these disclosure requirements significantly inhibit an enterprise's ability to "manipulate" depreciation expense to achieve predetermined earnings or other objectives.**

The FASB has identified a variety of qualitative characteristics that enhance the usefulness of financial statement information. The primary desirable characteristics of accounting information are:

- *Relevance* – The information has feedback value (confirms or corroborates users' prior expectations) and predictive value (can be used in a "predictive process"), and it is available in a timely fashion.
- *Reliability* – The information is "representationally faithful" (valid), neutral (unbiased), and verifiable.

In a depreciation context, these characteristics would be manifest if the reported amounts are relevant to financial statement users' decisions related to an enterprise's future earnings potential, future investment requirements and the integrity of the carrying value of existing assets; accurately allocate asset costs over their useful lives; and are unbiased (neither too short or too long) and verifiable.

Several parties are responsible for the integrity of an enterprise's financial statements. The primary responsibility rests with management who is required to establish an appropriate control environment, identify financial risks, safeguard assets, properly authorize all transactions, and minimize the risk of fraudulent financial reporting. The knowing and willful communication of false and fraudulent financial information by management can result in termination of employment, lawsuits against the individual(s) or corporation, fines, and imprisonment. These are strong deterrents to fraudulent financial reporting, including the potential manipulation of depreciation expense to achieve earnings goals.

Additional oversight over financial reporting is provided by the audit committee of the board of directors, who in turn rely on assurance provided by the company's internal and independent auditors. Internal auditors focus on the company's system of internal controls, evaluate conformance with other corporate policies, and assist in the independent audit. Internal auditors generally have direct access to the audit committee and are an important part of the control environment.

Independent auditors examine financial statements to ensure that they present fairly the company's financial position, results of operations, and cash flows in conformity with GAAP. These examinations must be conducted in accordance with GAAS. Independent auditors are required by the American Institute of Certified Public Accountants (AICPA) to communicate with the audit committee on matters related to, among others, significant accounting policies, management judgments and accounting estimates and disagreements with management. Professional reputation for independence, honesty, and integrity is the most valued asset of the individual independent auditor and his or her firm. The penalties for failing to comply with the professional standards are severe and can include loss of the client, investigations by the ethics authorities representing the AICPA and state agencies, loss of the auditor's CPA license, suspension or revocation of the rights to practice before the SEC, and fines and imprisonment if it is established that the auditor was engaged in fraudulent financial reporting.

Among the depreciation-related items that would be tested by an independent auditor are: reasonableness and consistency of depreciation methods, reasonableness and consistency of calculations, and reasonableness of estimated lives (e.g., using benchmarks). In a capital-intensive company, such as regulated common carriers, considerable audit emphasis would be placed on depreciation accounting because of its significance.

## **Introduction**

In the Notice of Proposed Rulemaking (NPRM) in CC Docket No. 92-296, *In the Matter of: Simplification of the Depreciation Prescription Process*, released December 29, 1992, the Federal Communications Commission (the Commission or FCC) is considering four options to streamline and simplify the depreciation prescription process. One potential obstacle to reducing the regulatory burden currently imposed as a result of prescribing depreciation rates is the Commission's desire not "to provide unreasonable incentives for carriers to make depreciation decisions on the basis of their effect on earnings."<sup>1</sup>

In response to the Commission's concern, the United States Telephone Association and numerous Local Exchange Carriers (LECs) identify and describe in their comments various safeguards relating to capital recovery that the Commission could employ to discharge its responsibilities under the Communications Act and to protect the public interest. The safeguards currently in place include: the Uniform System of Accounts, ARMIS reporting, the endogenous treatment of depreciation expense within the price cap framework, the access tariff review process, the presence or imminent presence of competition, state regulators' reviews of depreciation rates, audits by the Commission's staff, and the authority of the Commission (under the Communications Act) to compel the production of documents and to fine or imprison parties who make false entries in their books.

Additional possible safeguards that have been suggested by the LECs for the Commission's consideration include: establishing depreciation rates in the first quarter of the year and not allowing any adjustments to those rates during the year; requiring that depreciation rate changes always be prospective; and tracking depreciation changes over a multi-year time span to detect abnormal trends that could be called into question.

One safeguard mentioned repeatedly in the comments is the presence of Generally Accepted Accounting Principles and the requirement that companies adhere to these principles in

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<sup>1</sup>Notice of Proposed Rulemaking in CC Docket No. 92-296, 1992, paragraph 20.

the preparation of their financial statements. Given the severity of the consequences of violating GAAP, we believe that these principles act as a strong deterrent to counteract any potential incentives to manipulate earnings. The purpose of this report is to support this opinion.

In connection with this docket, we believe that it is important to note that the Commission is not proposing to change the asset valuation method (original/historic cost), the depreciation allocation methods (equal life group and remaining life), or the methods employed to estimate average service lives. Thus, this docket relates only to the Commission's depreciation prescription process; state regulatory agencies will continue to review and prescribe the depreciation rates for the intrastate operations of the carriers.

In the following sections, we discuss the purpose of financial reporting and describe how GAAP improves the quality and usefulness of financial information. We also focus on how GAAP specifically relates to depreciation accounting and operates to constrain any carrier's ability to manipulate depreciation expense. The following section summarizes the institutional framework relied on by investors, lenders, creditors, and other interested parties to ensure the integrity of financial information. This framework consists of a series of checks and balances defined by the roles and responsibilities of management, the board of directors as represented by its audit committee, the internal auditor, and the independent auditor. As will be noted, a violation of GAAP can result in severe consequences to the individual and the company involved. The final section of this report discusses the audit considerations regarding depreciation, including the audit procedures for determining the reasonableness of depreciation lives and accruals.

### **Purpose of Financial Reporting**

Financial reporting summarizes accounting information, including information related to depreciation. It is designed to provide this information in a format useful to shareholders, lenders, creditors, and other interested parties who focus on the financial status of the enterprise. More specifically, the primary role of financial accounting and reporting is to:

... serve the public interest by providing information that is useful in making business and economic decisions. That information facilitates the efficient functioning of capital and other markets, thereby promoting the efficient and equitable allocation of scarce resources in the economy.<sup>2</sup>

In the late 1970s, the Financial Accounting Standards Board conducted a major review of the objectives of general purpose financial reporting. In selecting from a large set of possible objectives, the FASB concluded that there are three primary objectives of financial reporting:

1. To provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions.
2. To provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts.
3. To provide information about the economic resources of an enterprise; the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity); and the effects of transactions, events, and circumstances that change its resources and claims to those resources.<sup>3</sup>

The American Institute of Certified Public Accounts in *APB Statement No. 4* (1970) and the FASB in its *SFAC No. 1* make it clear that financial reporting information is useful only if it is relevant to the economic decisions that users make about the activities of the reporting business enterprise. Therefore, the primary criterion for judging the quality of accounting information is relevance—the ability of information to make a difference in a decision. Two secondary criteria for judging the quality of accounting information are reliability (i.e., data must be verifiable, neutral and measurable) and comparability (i.e., data must be consistent). As discussed below, these qualitative characteristics of accounting information are achieved through the use of GAAP.

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<sup>2</sup>Reed K. Storey in D. R. Carmichael, Steven B. Lilien, and Martin Mellman, eds., *Accountants' Handbook*, 7th ed., chapter 1, p. 2, New York: John Wiley & Sons, 1991.

<sup>3</sup>FASB, *Statement of Financial Accounting Concepts Number 1: Objectives of Financial Reporting by Business Enterprises*, November 1978.

## **Purpose of Generally Accepted Accounting Principles**

The purpose of GAAP is to improve the quality and usefulness of corporate financial reports. In 1970, the Accounting Principles Board (APB) issued a definition of GAAP:

Financial statements are the product of a process in which a large volume of data about aspects of the economic activities of an enterprise are accumulated, analyzed, and reported. This process should be carried out in accordance with generally accepted accounting principles. Generally accepted accounting principles incorporate the consensus at any time as to which economic resources and obligations should be recorded, how the recorded assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared.<sup>4</sup>

In essence, GAAP specifies how individual types of transactions are to be reported in a firm's financial statements in order to be consistent both with accounting theory and the underlying economic reality that accounting theory attempts to reflect. GAAP functions as a prescriptive mechanism which acts, to a greater or lesser extent depending upon the specificity of GAAP with respect to a certain type of transaction, to constrain and restrict the accounting treatment of transactions, including reported amounts of depreciation.

The Securities and Exchange Commission is the body in which Congress has vested legal power to prescribe and enforce general accounting principles for most firms that issue and trade securities in the United States. The Securities Act of 1933 and the Securities Exchange Act of 1934 both require companies with registered securities to file audited financial statements according to the accounting principles prescribed by the SEC. The SEC's power to enforce GAAP resides in its authority to regulate stock exchanges. Although the SEC retains ultimate control concerning the establishment of GAAP, it has delegated that authority to the FASB. Prior to the establishment of the FASB in 1972, this delegated authority rested with the Committee on Accounting Procedure (from 1938 to 1959) and the Accounting Principles Board (from 1959 to 1973). To enforce its pronouncements, in 1964 the AICPA issued ethics Rule 203

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<sup>4</sup>AICPA, APB Statement No. 4: Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, October 1970, section 137.

which requires an auditor to qualify his or her opinion on any financial statement that does not conform to the official standards of the AICPA or its delegated agent. With Accounting Series Release No. 150 in 1973, the SEC recognized the FASB as the standards setter for GAAP.

### **Depreciation Under GAAP**

Previous sections of this document have briefly discussed the purpose of financial reporting and the role GAAP plays in promoting the qualitative characteristics of accounting information in general. In this section, we will focus on the application of GAAP to the specific area of depreciation accounting and the criteria (both theoretical and practical) that govern the development and implementation of depreciation accounting practices. Also, we will address the following topics:

- The characteristics of accrual accounting that give rise to the need for depreciation accounting.
- Promulgated GAAP as it applies to depreciation accounting.
- Desirable qualitative characteristics of financial information and their role in depreciation accounting.
- Practical considerations in implementing depreciation accounting.

Overall, the objectives of this section are to describe the financial statement and accounting context in which depreciation accounting occurs and the related constraints imposed on depreciation accounting.

### **The Need for Depreciation Accounting**

Depreciation accounting is one aspect of the implementation of accrual accounting, the need for which arises from the fact that investors in modern business enterprises demand periodic reports on the enterprise's operating performance. It is widely recognized that the ultimate

~~success or failure of a business enterprise is judged by its ability to generate cash. As the FASB~~

Business enterprises, like investors and creditors, invest cash in noncash resources to earn more cash. The test of success (or failure) of the operations of an enterprise is the extent to which the cash return exceeds (or is less than) the cash spent (invested) over the long run. A successful enterprise receives not only a return of its investment, but also a satisfactory return on that investment.<sup>5</sup>

However, only when an enterprise's operations are terminated and the enterprise liquidated (converted into cash) can the enterprise's cash-generating ability be fully and finally determined. Prior to the late 1800s, this was precisely how the success or failure of an enterprise was measured. Today, on the other hand, investors, lenders, and creditors all demand information on the financial performance of an enterprise on a more timely basis, i.e., through periodic financial reports. Accrual accounting was developed in recognition of the fact that short-term cash flows reflect a variety of transactions (e.g., asset acquisitions, dividend payments, debt repayments) that have little to no relation to the enterprise's long-term ability to generate cash. Accrual accounting has been defined by the FASB as follows:

Information about enterprise earnings and its components measured by accrual accounting generally provides a better indication of enterprise performance than information about current cash receipts and payments. Accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for an enterprise in the period in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise. Accrual accounting is concerned with the process by which cash expended on resources and activities is returned as more (or perhaps less) cash to the enterprise, not just with the beginning and end of that process.<sup>6</sup>

Consequently, measurement of a company's long-term ability to generate cash requires identification of cash-using or cash-generating operating events in the period the event occurs, not when the related cash flows occur. Under accrual accounting, operating events that will eventually increase cash are called revenues, and operating events that will eventually consume

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<sup>5</sup>FASB, Statement of Financial Accounting Concepts Number 1: Objectives of Financial Reporting by Business Enterprises, November 1978, paragraph 39.

<sup>6</sup>*Ibid.*, paragraph 44.

cash are called expenses. Matching these revenues and expenses during a period results in a periodic measure of net long-term cash-generating ability called earnings. Over the life of an enterprise, earnings will by definition equal the enterprise's net increase or decrease in cash. Over any shorter period, earnings and cash flow will almost inevitably differ.

The cornerstone of accrual accounting is the matching principle. In a somewhat extended discussion, the FASB has specified the meaning and import of the matching principle, including highlighting the role of depreciation accounting in meeting this principle.

Accrual accounting uses accrual, deferral, and allocation procedures whose goal is to relate revenues, expenses, gains and losses to periods to reflect an entity's performance during a period instead of merely listing its cash receipts and outlays. Thus, recognition of revenues, expenses, gains and losses, and the related increments or decrements in assets and liabilities—including matching of costs and revenues, allocations, and amortization—is the essence of using accrual accounting to measure performance of entities. The goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable.

Matching of costs and revenues is simultaneous or combined recognition of the revenues and expenses that result directly and jointly from the same transactions or other events. In most entities, some transactions or events result simultaneously in both a revenue and one or more expenses. The revenue and expense(s) are directly related to each other, and require recognition at the same time . . . .

Many expenses, however, are not related directly to particular revenues but can be related to a period on the basis of transactions or events occurring in that period, or by allocation. Recognition of those expenses is largely independent of recognition of particular revenues, but they are deducted from particular revenues by being recognized in the same period . . . .

Many assets yield their benefits to an entity over several periods, for example prepaid insurance, buildings, and various kinds of equipment. Expenses resulting from their use are normally allocated to the periods of their estimated useful lives (the periods over which they are expected to provide benefits) by a 'systematic and rational' allocation procedure, for example by recognizing depreciation or other amortization. Although the purpose of expense allocation is the same as that of other expense recognition—to reflect the using-up of assets as a result of transactions or other events or circumstances affecting an entity—allocation is applied if causal relations are generally, but not specifically, identified. For example, wear and tear from use is known to be a major cause of the expense called depreciation, but the amount of depreciation caused by wear and tear in a

period normally cannot be measured. Those expenses are not related directly to either specific revenues or particular periods. Usually no traceable relationship exists, and they are recognized by allocating costs to periods in which assets are expected to be used, and are related only indirectly to the revenues that are recognized in the same period.<sup>7</sup>

Thus, the need for depreciation accounting arises from the fact that property plant and equipment (an asset) is purchased (cash is expended) for the most part prior to the period of time when the asset is used for cash-generating activities. In order to match the cash used to purchase an asset, as a periodic expense of the enterprise, with the period over which the enterprise obtains the economic benefits of the asset (and, directly or indirectly, generates cash thereby), the initial cash outlay is allocated over the period during which the economic benefits are obtained and reported as depreciation expense on the enterprise's financial statements. An allocation of asset costs to the periods in which they are expected to be used produces a better match between revenue-generating events and cash-consuming events than would a simple statement of cash inflows and outflows.

### Depreciation and GAAP

The transformation of theoretical accounting principles into specific accounting procedures and practices in order to fairly represent financial results is the realm of generally accepted accounting principles. This will be addressed in the following subsection.

There are two principal constraints embodied in promulgated GAAP over depreciation accounting. The first is that the cost of an asset must be allocated over the estimated useful life in a systematic and rational manner. This constraint is stated in a 1953 AICPA pronouncement as follows:

The cost of a productive facility is one of the costs of the services it renders during its useful economic life. Generally accepted accounting principles require that this cost be spread over the expected useful life of the facility in such a way

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<sup>7</sup>FASB, Statement of Financial Accounting Concepts Number 6: Elements of Financial Statements, December 1985, paragraphs 145-149.

as to allocate it as equitably as possible to the periods during which services are obtained from the use of the facility. This procedure is known as depreciation accounting, a system of accounting which aims to distribute the costs or other basic value of tangible capital assets, less salvage (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation.<sup>8</sup>

An alternative but substantially similar description of depreciation accounting under GAAP is:

A system of accounting which aims to distribute the cost or other basic value of tangible capital assets, less salvage value (if any), over the estimated useful life of the unit (which may be a group of assets) in a systematic and rational manner. It is a process of allocation, not of valuation. Depreciation for the year is the portion of the total charge under such a system that is allocated to the year. Although the allocation may properly take into account occurrences during the year, it is not intended to be a measurement of the effect of all such occurrences.<sup>9</sup>

The second basic principle under GAAP governing depreciation, one that is less relevant in this context given the FCC's detailed rules for determining asset values,<sup>10</sup> is that assets must not be written up to appraisal, market or current values; rather, original/historical costs must be reflected. The AICPA has stated that "property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above costs to the entity."<sup>11</sup> In essence then, promulgated GAAP imposes constraints on depreciation accounting that have, in turn, defined the main depreciation issues:

1. The total depreciation charged for an asset over its useful life cannot exceed the asset's cost less salvage value. This provision essentially states that no more than the total cost of the asset, as defined by Part 32, Uniform System of Accounts for telecommunications carriers, can be written off through depreciation expense.

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<sup>8</sup> AICPA, Accounting Research Bulletin Number 43: Restatement and Revision of Accounting Research Bulletin

2. Depreciation expense should distribute an asset's cost over its estimated useful life. One of the principal issues in this docket is the constraints outside of the regulatory process that companies face in implementing depreciation policies. The primary focus of these concerns is on the useful life of regulated assets.
3. The allocation of asset costs over their estimated useful lives must be systematic and rational as well as equitable. These requirements are subsumed under the reliability and relevance standards promulgated in the FASB's *Statements of Financial Accounting Concepts*.

In addition to the GAAP constraints on depreciation accounting noted above, GAAP also provides standards for companies that change depreciation methods (a change in accounting principle) and asset lives (a change in accounting estimate). In general, the standards for implementing and disclosing changes in an accounting principle (such as a change from a straight line to an accelerated method of depreciation or a change from accrual to current period accounting for salvage) are more stringent than those standards based on changes in accounting estimates (such as alterations in estimated useful lives). As stated by the Accounting Principles Board:

In the preparation of financial statements there is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users by facilitating analysis and understanding of comparative accounting data.<sup>12</sup>

Because changes in depreciation methods have proven to be complex in practice, the APB devoted considerable attention to this issue, including laying out an extensive example in Appendix A of APB 20. Generally, a change in depreciation method does not result in retroactive restatement of prior financial statements; however, the cumulative effect of the new

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<sup>12</sup>AICPA, *APB Opinion Number 20: Accounting Changes*, July 1971, paragraph 15.

depreciation method should be charged to net income in the period during which the change is made.

With respect to accounting estimates, the APB observed that:

Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements. Preparing financial statements requires estimating the effects of future events. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, warranty costs, periods benefited by a deferred cost, and recoverable mineral reserves. Future events and their effects cannot be perceived with certainty; estimating therefore requires the exercise of judgment. Thus accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained.<sup>13</sup>

Changes in accounting estimates typically only apply prospectively, and they do not require either a charge or credit to net income in the period made nor a restatement of previous periods' financial results. Disclosure of the effects of changes in accounting estimates is required only for the current period except in unusual circumstances, while considerably more detailed disclosure requirements apply to changes in accounting principles.<sup>14</sup>

In practice, companies materially change their depreciation methods and lives very infrequently. In the 1992 annual survey of 600 companies' annual reports conducted by the AICPA, it was found that only 4 companies reported changing depreciable lives and 5 companies reported changing depreciation methods in 1991. Similar results were found in previous surveys.<sup>15</sup>

GAAP also requires companies to report specific types of information about their depreciation policies in financial statements. In particular, the following items must be disclosed:

- Depreciation expense for the period.
- Account balances for major classes of depreciable assets, by nature of function.
- Accumulative depreciation, either by major classes of depreciable assets or in total.

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<sup>13</sup>Ibid., paragraph 10.

<sup>14</sup>Ibid., paragraphs 33 and 19.

<sup>15</sup>Jack Shohet and Richard Rikert, eds., 1992 Accounting Trends & Techniques, AICPA, 1992, p. 41.